Internal Revenue Service

memorandum

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Br2:PLBurquest-Fultz

date: AUG 23 1988

to: District Counsel, Kansas City CC:KCY
Attention: Robert M. Fowler

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This memorandum is in response to your request for technical advice regarding the status of various individuals as employees or independent contractors of a church-sponsored day care program.

ISSUES

1. Whether day care workers of a child care program, organized by the [redacted] and administered by a director appointed by a Church committee, are employees of the Church for purposes of FICA tax and federal income tax withholding.

2. Whether the director of the program is an employee of the Church for purposes of FICA tax and federal income tax withholding.

3. Whether the facts described in this memorandum would support the granting of relief from Service treatment of the director and teachers as employees for any prior period pursuant to the provisions of section 530 of the Revenue Act of 1978.

CONCLUSIONS

1. The day care workers (also called teachers in this memorandum) are properly characterized as employees of the Church for purposes of FICA tax and federal income tax withholding.

2. The director of the child care program is properly characterized as an employee of the church for purposes of FICA tax and federal income tax withholding.

3. Relief under section 530 of the Revenue Act of 1978 is most likely not available to the Church under the facts presented in this memorandum.

FACTS

In the early [redacted]'s, [redacted] (hereinafter, "Church") formed a [redacted]. The committee was designed to be a non-integral part of the Church organization, so that the Church could easily and quickly divest itself from its activities, if desired. A program entitled "[redacted]" is carried out by the committee under the direction of an appointed director.

Members of the [redacted] are nominated and elected by Church members at the Church's annual meeting. The director is appointed by the committee. She is a member of the committee, but is not its chairperson. The director manages the program and has the responsibility for hiring, and firing of workers, as well as scheduling the program and supervising the workers. In addition, the director has substantial control over [redacted]; she has near final authority to administer decisions affecting the day-to-day operation of the program. However, the director can be terminated for poor performance by the committee chairperson.

The [redacted] differs from other Church committees because it is (indirectly) funded by fees charged to parents who place their children in the program. These payments are made directly to the Church. Vouchers are submitted to the Church treasurer, who pays all expenses, including the wages of the day care workers, (also called "teachers"), out of the Church treasury. Unlike other Church committees, the expense vouchers for the program are not subject to review by the Church Financial Committee. Further differences from other Church committees are as follows:

(1) Day care workers are not voted on for hiring by the church (unlike other paid workers of the Church);

(2) Wages paid to the workers are not set by the Church;

(3) Procedures regulating the program are not set by the Church; and

(4) The [redacted] is not required to report or gain Church approval for its decisions.

To summarize, although the [redacted] enjoys fewer restrictions than other Church committees, it is

funded by the Church (via [redacted] fees and, theoretically, other church funds) and generally operates under Church guidance and policy. Although day-to-day operations of the program are carried out by a director, that director is appointed by the Church (via the committee) and can be fired by the committee. Thus, the director is ultimately reportable to the committee, which reports to the Church. Accordingly, we have assumed that the [redacted] and the [redacted] program operate in an agency capacity on behalf of the Church.

The [redacted] director has the right to control the manner in which work is performed by the teachers and to set their hours of work for the program. The work is performed on the [redacted] premises under the direction and guidance of the program director. Wages are paid monthly based on the number of hours worked by each teacher. The teachers may work for more than one day-care program at a time or offer babysitting services to the general public. Either the director or the individual teacher may terminate the employment relationship at any time.

The [redacted] program generally provides equipment, supplies, and materials for the teachers' use. However, on some occasions, teachers may provide their own supplies or use their own cars to transport children to various activities. Such participation by the teachers is not required, and reimbursement for out-of-pocket costs may not be sought. In those cases in which the voluntary expenditure by a particular teacher exceeds the hourly wage for that day, the teacher may theoretically realize a loss from the day's teaching activities; however, as a practical matter, no teacher will recognize an overall loss from teaching activity. Because all expenditures (other than voluntary teacher expenditures) of the [redacted] Program are paid out of the Church treasury upon submission of program expense vouchers, neither the director nor the program itself can suffer an economic loss from operation of the program.

The Church has historically treated the day-care workers and the director as independent contractors and has issued Forms 1099 annually. Accordingly, no federal income tax is withheld from wages paid to these persons. Other paid workers of the Church are treated as employees and their wages are included for withholding tax and FICA tax purposes on the Church's quarterly Form 941 returns. However, before the repeal of section 3121(k) by the Social Security Act Amendments of 1983, the Church did not withhold FICA tax from wages paid to employees. No exemption from FICA taxes has been sought via the filing of a Form 8274. There have been no audits, employment tax or otherwise, of the Church.

LAW AND DISCUSSION

Issue 1:

I.R.C. § 3402 requires employers to withhold federal income tax from the wages paid to employees. Similarly, I.R.C. §§ 3102 and 3111 require employers to pay FICA tax with respect to wages paid to employees and to withhold the employees' share of FICA from those wages. The terms "employer" and "employee" are defined by statute and by regulation.

For federal income tax withholding purposes, the regulations provide that,

> ...the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

Treas. Reg. § 31.3401(c)-1(b). Other factors indicative of the relationship include the furnishing of tools and a place to work for the person providing services, and the existence of the right to discharge the service provider by the person for whom services are performed.

For FICA tax purposes, the regulations provide that corporate officers are employees. In addition, an individual is an employee "if under the usual common law rules the relationship between him and the person for whom he performs services is the legal relationship of employer and employee." See Treas. Reg. § 31.3121(c)(1). Application of common law principles was carried out via the examining agent's questionnaire. Responses to those questions indicate that the teachers should be classified as employees of the [redacted] program. This conclusion is supported by the following discussion.

Facts indicating an employer-employee relationship between the teachers and the program (i.e., Church) include: 1) the director supervises the teachers, thereby exercising her right to direct and control the manner in which services are performed; 2) the director can fire teachers for poor performance at any time; 3) the teachers can terminate employment with the program at any time; 4) as a general rule, services are performed on the Church program premises using

program materials, supplies, and equipment; 5) the personal services of the teachers comprise an integral part of the business in which the program engages (i.e, day care services); 6) the teachers receive an hourly wage (determined by the program) and are paid monthly based on the number of hours worked; and 7) there is no reasonable possibility of realizing an economic loss from teaching activities in the program.

Facts which often indicate an independent contractor relationship which are present in the facts of this case include: 1) the non-exclusivity of the employment relationship; 2) the theoretical ability of teachers to hire helpers at their own expense (per Revenue Officer Sinclair's informal discussions with Church officials); and 3) the theoretical lack of a continuing relationship between the program and the teachers (i.e., the teachers are apparently not committed to a specific number of hours per week and may work sporadically over time). The facts supporting classification of an independent contractor relationship resulted from Church officials' response to questions by the Revenue Officer Sinclair from a check list of common law factors. Revenue Officer Sinclair has characterized these responses as in the nature of theoretical possibilities which could occur under the current operation of the program, but which do not necessarily represent the general rule for operation. On the basis of this characterization, these facts are overwhelmingly outweighed by facts indicating the existence of an employer-employee relationship. We also note that the nonexclusivity of the employment relationship and the practice of permitting teachers to work as few hours as they would like per week are facts that are not inconsistent with part-time employment status. Accordingly, we have concluded that the teachers are employees of the [redacted] which operates, in this capacity, as an agent for the Church.

We have assumed that [redacted] is an organization described in section 501(c)(3) and as such, is exempt from income taxation under section 501(a). Based on its status as a section 501(c)(3) organization, it is also exempt from FUTA tax. I.R.C. § 3306(c)(8). Prior to the enactment of the Social Security Amendments of 1983, services performed by individuals employed by a religious organization described in section 501(c)(3) were covered by social security only if the organization waived, or was deemed to have waived, its exemption from the imposition of FICA taxes. Section 3121(b)(8)(B). However, section 102 of the 1983 Amendments requires that wages paid for services of these individuals be subject to FICA tax. Congress later provided elective relief to churches and qualified church-controlled organizations who are opposed for religious reasons to the payment of the employer's share of the

FICA tax[1]; no election has been filed by the Church. Thus, for services performed prior to January 1, 1984, no FICA withholding was required for [redacted] teachers; however, for services performed after that date, FICA tax is applicable to the wages paid to the teachers.

Based on the teachers' status as employees of the program, wages paid for services performed is also subject to federal income tax withholding. In contrast to section 3121(w), there is no election applicable to 501(c)(3) organizations to elect out of federal income tax withholding.

Issue 2:

The conclusions stated above apply equally to the director of the program. Although she has some decision-making authority, she is answerable to the committee and can be terminated for poor performance by the committee chairperson. Her discretionary authority to run the program is consistent with that of a managerial employee. Furthermore, because the program is funded entirely by funds from the Church treasury (and by operation, indirectly by program income), the director has no economic investment in the outcome of the program. She cannot realize a loss for her participation in the program. Accordingly, we conclude that the director is also an employee of the Church whose wages are subject to FICA and federal income tax withholding.

Issue 3:

Although we have concluded that the teachers and director are employees of the Church, we next must consider whether the relief provision of section 530 of the Revenue Act of 1978, 1978-3 (Vol. 1) C.B. xi, 119, is applicable to permit classification of these individuals as independent contractors until an examination is instituted, thereby notifying the taxpayer of the proper status of the employment relationship. In Rev. Proc. 85-18, 1985-1 C.B. 581, the Service announced that it will apply the relief provisions of section 530 for any period after December 31, 1978, if the employer had a reasonable basis for not treating an individual as an employee and:

> (1) all federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period are filed on a basis consistent with the taxpayer's treatment of the individual as not being an employee, and

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[1] See section 3121(w).

(2) the treatment is consistent with treatment for periods beginning after December 31, 1977.

Rev. Proc. 85-18. As described in the facts above, the Church has consistently treated the teachers and the director as independent contractors and has issued Forms 1099 under that status in all prior years. Thus, it appears that the last two requirements of the revenue procedure have been met.

We now must determine whether the Church had a "reasonable basis" for not treating these individuals as employees. The revenue procedure provides several "safe havens" for making this determination. Among other things, reasonable reliance on judicial precedent or published rulings, or on technical advice, a letter ruling or a determination letter pertaining to the taxpayer will form a sufficient "reasonable basis" under section 530. Additionally, reasonable reliance on a long standing recognized practice of a significant segment of the day care industry (even if the practice is not uniform throughout the industry) would meet the "reasonable basis" standard for relief under section 530. The following paragraphs discuss administrative and judicial authority dealing with the characterization of individuals performing services for the [redacted] program.

In 1953, the Service announced that babysitters performing services for the customers of an establishment offering babysitter services to the general public and providing rules of conduct and supervising the manner of performance of the services will be considered employees of the establishment. As employees, their wages were subject to withholding of income tax. See Rev. Rul. 233, 1953-2 C.B. 294. In Rev. Rul. 56-502, 1956-2 C.B. 688, the Service announced that individuals engaged by an agency to perform services (including babysitting services) for the agency's clients would be considered employees of the agency where facts show that: (1) the agency is engaged in the business of providing such services and holds itself out to the general public as such; (2) the agency determines the amount of remuneration to be received by the individuals; (3) the parents look to the agency for duly qualified and trained individuals; (4) the services are necessary to the conduct of the agency's business and promote its business interests; and (5) the total business income of the agency is derived through the services provided by the individuals. The ruling noted an exception to this general rule where the agency was licensed or registered under state or municipal law as an employment agency which functions to furnish applicants for employment to prospective employers and is subject to any applicable laws and regulations respecting the charging of fees, the maintenance or an employment register, etc.

Rev. Rul. 56-502 was later clarified by Rev. Rul. 74-414, 1974-2 C.B. 334, which also held that babysitters were employees of a licensed babysitting agency for purposes of FICA, FUTA, and federal income tax withholding. The clarification resulted from the ruling's statement that Rev. Rul. 56-502 should not be interpreted to mean that the factor of licensing, in itself, would control the status of the babysitters as employees or non-employees. Instead, the determining factor should be whether the babysitters are subject to the will and control of the agency not only as to what shall be done but how it shall be done. Where the agency has the right to direct and control the manner in which the services are performed (regardless of whether that right is exercised), the babysitters will be considered employees of the agency. This clarification became effective with respect to remuneration received by babysitters in calendar quarters beginning after August 26, 1974. Rev. Rul. 74-414 was later revoked by Rev. Rul. 80-365, 1980-2 C.B. 300, with respect to remuneration received by babysitters after December 31, 1974. The revocation resulted from the enactment of section 3506, in Pub. L. No. 95-171, 1978-1 C.B. 457, 458, which provides that for federal employment tax purposes, a person engaged in the trade or business of putting babysitters in touch with its clients, will not be treated as the employer of the babysitters if such person does not pay or receive the salary or wages of the sitters and such person is compensated by the sitters or the persons who employ them on a fee basis. The ruling further modifies Rev. Rul. 56-502 by retaining the clarification regarding licensing under state or local law discussed above, (applicable to remuneration for calendar quarters beginning after August 26, 1974), but restricting the general rule cited in the ruling to those situations where the agency pays the babysitters directly for services performed for its clients.

The above rulings discuss circumstances in which babysitters work for an agency with clients needing babysitting services in the clients' homes or in the babysitters homes.[2] Although the rulings are factually distinguishable from the

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[2] In Rev. Rul. 74-45, 1974-1 C.B. 289, the Service concluded that a trained babysitter who performed day-care services for a county approved organization was an employee of that organization because the organization retained the right to determine the nature of the services to be performed and the manner of performances of such services. In Conference Committee Discussion of Rev. Rul. 74-414, GCM 36967, I-429-76 (Dec. 17, 1976), the Service stated that because the conclusion in Rev. Rul. 74-45 was not based on an analysis of the requirements set forth in Rev. Rul. 56-502, a sitter can be an employee of an organization even if the organization does not satisfy Rev. Rul. 56-502.

facts describing the [redacted] program, the general rule set forth is that the existence of an employment relationship is a factual determination, and that if the following facts are present, an employer-employee relationship will be deemed to exist. Those factors are: (1) the "employer" has the right to control the manner in which services will be provided by the sitters; (2) the "employer" holds itself out as providing qualified individuals to perform babysitting services to the general public and those services are integral to its business operations; (3) the total business income of the "employer" is derived through the services of the "employees," and (4) the customers pay the "employer" for the services rendered, who in turn, compensates the babysitters. Application of this general rule to the facts involving the [redacted] program would support characterization of the teachers and the director as employees of the Church.[3] Therefore, administrative authority would not support an assertion by the Church that it had a reasonable basis to classify these individuals as independent contractors.[4]

Judicial authority in the specific area of babysitting (or day care) services is sparse. In 1968, the Tax Court ruled in a memorandum decision that a babysitter was an employee of the parents of the children for whom she babysat and not for the agency from whom she received her babysitting jobs. See Hodgkinson v. Commissioner, T.C. Memo. 1968-176. In Hodgkinson, the taxpayer registered and contracted with an agency and agreed to pay a commission of 12 1/2 percent in return for the agency's listing of her name and procuring jobs for her. All jobs were arranged through the agency; however, her calendar of jobs was under her sole discretion. All babysitting was done in the homes of the agency's customers. If the parents instructed taxpayer as to the specific needs of the child (i.e., feeding schedules, bedtime storytelling, singing to the child before sleep, etc.) she complied with the instructions. If no instructions were left, care was within her sole discretion.

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[3] The "licensing" exception (if applicable) created by Rev. Rul. 56-602 would permit treatment of service providers as independent contractors for calendar quarters beginning before August 16, 1974. This effective date was contained in Rev. Rul. 80-365's clarification of Rev. Rul. 56-602, following the same effective date for modifications to that ruling by Rev. Rul. 74-414. In other words, the "licensing" exception created by language used in 56-602 would remain in effect until it was initially modified by Rev. Rul. 74-414.

[4] We have located a private letter ruling (PLR 8707047) which supports the position taken in this memorandum that day-care workers of a church operated day-care center are employees.

She required all parents to leave a number where they could be reached in case of emergency.

The issue in Hodgkinson was the application of self-employment tax (under section 1401) to the income realized from the jobs. Relying on the definition of employee contained in section 3121(d),[5] the court stated:

> The fundamental common law test used to determine if an individual is an employee is whether the party said to be his employer has the right to control the individual's activities, not only as to the results to be accomplished by the work but also as to the means and methods to be used in accomplishing the result. Alsco Storm Windows, Inc. v. United States, 311 F.2d 341 (9th Cir. 1962). See generally Seavey, Law of Agency, sec. 84.

27 T.C.M. (CCH) 865, 866. Applying this test, the court found that the taxpayer was subject to the control of the parents for whom she babysat. In support of this finding the court stated that following the parents' instructions as well as requiring a number where they could be contacted in case of emergency indicated that she was under the parents' control. Accordingly, she was not self-employed or an employee of the agency.

The facts of Hodgkinson are also distinguishable from those involving the [redacted] program. Specifically, the director supervises the performance of the teachers; the committee effectively supervises the performance of the director; substantially all work is performed on the program's premises; the parents contract for day-care services through the program and do not choose which teacher will care for their child; all payments are made to the church based on the time the child is in the program; there is no relationship to the number of hours worked by a particular teacher in determining the child care fees; and only the director can hire or fire the teachers in the program. Under these facts, it would be unreasonable to conclude that either the teachers or the director were subject to control of the parents of the children in the program. However, it could be concluded that the teachers were under the control of the director and the director was under the control of the Church committee.

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[5] One of the definitions of an employee contained in section 3121(d) provides that "any individual who, under the usual common law rules applicable to determining the employer-employee relationship, has the status of an employee" will be treated as an employee for FICA purposes.

Furthermore, the court applied common law factors to determine the existence of control over the babysitter. As discussed earlier, the application of common law factors to the facts presented in the [redacted] program would indicate that the teachers and the director were employees of the Church. Based on the foregoing discussion, we have been unable to locate any judicial authority which would form a reasonable basis on which the Church could rely to support treatment of the teachers as independent contractors.

We conclude that section 530 will most likely not provide relief to the Church in their treatment of these individuals as independent contractors. This conclusion is based on our opinion that the safe havens provided in Rev. Proc. 85-18 cannot be relied on by the taxpayer to meet the "reasonable basis" standard required. As discussed above, we could not locate any administrative or judicial authority which would support characterization of the teachers or the director as independent contractors. We have assumed, based on the facts provided, that no audits (employment tax or otherwise) of the Church's returns have been initiated, nor has technical advice or a private letter ruling been issued to the Church. We have furthermore assumed, based on the rulings discussed above, that industry practice is such that workers of a day-care center in which the director has supervisory authority and the power to hire and fire, are generally treated as employees of the center. Accordingly, unless the Church is able to show in some manner beyond those discussed in the safe havens provided in Rev. Proc. 85-18, that it had a reasonable basis for not treating the teachers as employees, section 530 will be inapplicable to the facts presented herein.

CONCLUSIONS

Based on the discussion provided above, we have concluded that both the director of the [redacted] program and the teachers providing services to the program are employees of the Church. Furthermore, we have concluded that the relief provisions under section 530 of the Revenue Act of 1978 are most likely inapplicable to protect the Church from reclassification of these individuals as employees.

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